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CHAIRMAN TOM PRICE, M.D.

GROWING RISKS TO THE BUDGET AND THE ECONOMY

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ABSTRACT

The Federal Government's fiscal policy remains on an unsustainable path. Deficits are growing once again and are expected to double over the next 10 years, to more than $1.2 trillion – on par with annual deficit levels reached just after the financial crisis earlier this decade (in nominal terms). Growing deficits are driving debt to dangerous levels. Debt held by the public is projected to rise from roughly 76 percent of gross domestic product this year to more than 85 percent by 2026, twice the average of the past 50 years (39 percent) and the highest level since the end of World War II. By 2046, this publicly held debt is expected to reach 141 percent of gross domestic product, surpassing the historical high of 106 percent that occurred just after World War II.

At the same time, the U.S. economy is mired in slow growth. Real economic growth has averaged just more than 2.0 percent the past five years, well below the U.S. historical average of roughly 3.0 percent and marking the weakest economic recovery of the modern era. From 1950 through 2000, the U.S. economy grew at about 3.6 percent per year; since 2000, it has grown at barely half that rate, 1.8 percent. Even one recent glimmer of hopeful economic news – an increase in real median household income in 2015 – required six years to occur and still left incomes below their pre-recession peak in 2007. Further, even though the poverty rate declined in 2015, it remained above its pre-recession level, with six million more poor people.

The answer to these twin problems is not more Keynesian-style government spending and borrowing. Instead, lawmakers should pursue pro-growth policies and strive to gain control of spending and deficits. This is the most promising combination for restoring growth, raising standards of living, and achieving a sustainable budgetary path.

AN UNSUSTAINABLE FISCAL PATH

The most recent figures by the Congressional Budget Office [CBO] provide a sober reminder that the government's fiscal policy, like the Nation's economy, is on the wrong path. The deficit this year will rise to $588 billion (3.2 percent of gross domestic product [GDP]), an increase of $149 billion from 2015. The widening deficit gap resulted from $168 billion (or 5 percent) in higher spending combined with just $19 billion (about 1 percent) more in revenue.[1] The deficit is expected to *double* over the next 10 years, to more than $1.2 trillion.[2] That is on par with annual deficit levels reached just after the financial crisis earlier this decade (in nominal terms).

Some argue that because deficits have declined in recent years, concerns about the government's fiscal condition are exaggerated. This ignores the exceptionally high levels (exceeding $1 trillion per year) from which deficits have dropped. Moreover, CBO's figures show deficit and debt levels are once again surging, and will soon approach dangerous levels. In fact, publicly held debt as a share of the economy is projected to rise from roughly 76 percent this year to more than 85 percent by 2026, twice the average level of the past 50 years (39 percent) and the highest since the end of World War II. CBO warns that "such high and rising debt would have serious consequences for the budget and the nation."[3] As baby boomers retire and entitlement costs soar, this share of debt will increase unabated in future years, absent reform. According to CBO's long-term budget projections released in July, publicly held debt as a share of GDP will jump to 141 percent in 2046 under current law.[4] That would surpass the historical maximum of 106 percent that occurred after World War II.

An ever-rising debt level is ultimately unsustainable because its growth eventually begins to exceed that of the overall economy. As a result, debt service costs absorb an increasing share of national income, and the country must borrow an increasing amount each year, likely in the face of gradually higher interest rates, both to fund its ongoing services and to make good on its previous debt commitments. Ultimately, this dynamic will cause a reduction in national saving and a crowding out of private investment, leading to a decline in economic output and a lowering of the country's standard of living.

This is not merely a hypothetical scenario or abstract economic theory. CBO's long-term projections show that the ever-rising debt levels under current law will lead to a smaller economy and less prosperity for every American. Compared to a future in which the government merely stabilized the debt at its current level of about 75 percent of GDP, the current-law path implies a real income loss of about $12,000 for the average family of four by 2046.[5]

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[1] Congressional Budget Office, *Monthly Budget Review for September 2016*, 7 October 2016.
[2] Congressional Budget Office, *An Update on the Budget and Economic Outlook: 2016 to 2026*, August 2016, Table 1-1, p. 12: https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51908-2016_Outlook_Update-2.pdf.
[3] Ibid. p. 3.
[4] Congressional Budget Office, *The 2016 Long-Term Budget Outlook*, July 2016, pp. 5-6. Publicly held debt is debt the government owes to outside investors. Total debt, which would include amounts the government owes to other government accounts, would be appreciably larger.
[5] Peter G. Peterson Foundation, *CBO: Long-Term Budget Outlook Worse Than Last Year*, 12 July 2016: http://www.pgpf.org/analysis/2016/07/cbo-long-term-budget-outlook-worse-than-last-year.

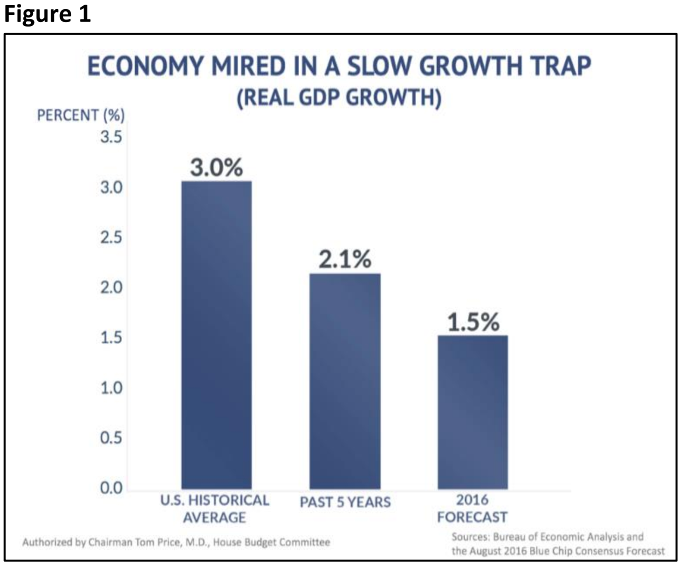
Some critics argue that reining in spending and getting debt levels under control amount to "fiscal austerity" that will harm the economy. Yet nearly all economists, including those at the CBO, find that reducing budget deficits, thereby bending the curve on debt levels, would be a net positive for economic growth over the long term. The logic is that deficit reduction increases the available pool of national savings and boosts investment, thereby raising long-term economic growth and job creation.

For instance, in an analysis of the fiscal year 2017 House budget resolution, which achieved $7 trillion in deficit reduction over 10 years and balanced the budget, CBO concluded that compared to the current-law baseline, real economic output per person (a proxy for a country's "standard of living") would be 1.7 percent higher, or about $1,100, in 2026 and 6.3 percent higher, or about $4,900, in 2040.[6]

AN ECONOMY MIRED IN SLOW GROWTH

The U.S. economy is caught in a slow-growth trap made worse by the current administration's fiscal and regulatory policies. During the first half of this year, real GDP growth has averaged a paltry 1.1 percent.[7] Barring a surge in the second half of the year, the economy is on pace for the weakest annual growth since the recession ended in 2009. Yet that surge appears unlikely. In a depressingly familiar refrain in the financial press, a recent story in *The Wall Street Journal* reported the growth malaise is "a familiar story for the U.S. economy since the recession ended in mid-2009."[8]

Figure 1



Real GDP has expanded by an average of just slightly more than 2.0 percent the past five years, well below the U.S. historical average of roughly 3.0 percent and marking the weakest economic recovery of the modern era. From 1950 through 2000, the U.S.

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[6] Congressional Budget Office, *Budgetary and Economic Outcomes Under Paths for Federal Revenues and Noninterest Spending Specified by Chairman Price*, March 2016: https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51260-BudgetaryPaths1.pdf
[7] Based on figures by the Bureau of Economic Analysis, U.S. Department of Commerce, 29 September 2016.
[8] "Optimism Fades for Economic Boost by Year-End," *The Wall Street Journal*, 16 September 2016: http://www.wsj.com/articles/optimism-fades-for-economic-boost-by-year-end-1473967595.

economy grew at about 3.6 percent per year. Since 2000, it has grown at barely half that rate, 1.8 percent.[9]

In one recent glimmer of positive economic news, the Census Bureau reported that real median household income rose by $2,800 (5.2 percent) in 2015 to $56,516.[10] President Obama called this "a big deal," while the Chairman of his Council of Economic Advisers boasted: "[T]his is unambiguously the best Income, Poverty & Health Insurance report ever." Yet the Census Bureau number "is a lot less meaningful than the advocates insist," says former CBO Director Douglas J. Holtz-Eakin."[11] For one thing, it reflects the slowest income recovery from a recession – six years – since the Census Bureau started documenting the data in the 1960s. In the previous six cyclical recoveries since that time, it took an average of just three years for household income to exceed its recession-ending level. In the current subpar recovery, it has taken twice that long. Even at that, real household income remains $900, or 1.6 percent, below its pre-recession peak in 2007.

Furthermore, an overlooked but important item in the Census Bureau report showed that real median earnings growth for full-time, year-round men and women was 1.5 percent and 2.7 percent, respectively, well below the headline income growth of more than 5 percent. This discrepancy between the growth of household income and individual earnings could be due to families adding a second worker in the household or people moving from part-time to full-time work. In any case, the underlying earnings growth reflects a Nation "stuck in a 2 percent economy."[12]

The Census Bureau report also showed a sizeable 1.2-percentage-point decline in the poverty rate in 2015, to 13.5 percent. Yet despite this positive development, the current poverty rate is still a full percentage point *above* the pre-recession level of 12.5 percent in 2007 – an increase of nearly six million people. In addition, the current poverty rate is still higher than at any point in the 2001-2007 business cycle. One of the best ways to reduce poverty levels in a society is to increase economic growth. For instance, in the early 1990s, the poverty rate stood at a peak of 15.1 percent. But at the end of the late-1990s economic boom, when the economy grew by an average of 4.4 percent a year, that rate had dropped to a 25-year low of 11.3 percent. That was not a coincidence.

Other economic data also reflect the economy's sluggishness. For instance, business fixed investment has declined for three consecutive quarters, the first such extended decline since the financial crisis and recession. Given the policy uncertainty in Washington and the government's unsustainable fiscal future, the reluctance to invest is not surprising. Investors and businesses make decisions on a forward-looking basis. They know that today's large debt levels are tomorrow's tax hikes and interest rate increases – and they act accordingly. The debt overhang, and the uncertainty it generates, can therefore weigh on growth, investment, and job creation today and in the future.

Some look to the labor market and see evidence of a brightening economy, and to a certain extent this is true. Although it has slowed from last year's rate, job growth has

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[9] John H. Cochrane, testimony before the Committee on the Budget, U.S. House of Representatives, 14 September 2016.
[10] Bernadette D. Proctor, Jessica L. Semega, Melissa A. Kollar, *Income and Poverty in the United States; 2015*, United States Census Bureau, September 2016.
[11] Douglas J. Holtz-Eakin and Patrick Hefflinger, "Not. So. Fast," American Action Forum, 15 September 2016: https://www.americanactionforum.org/daily-dish/not-so-fast/.
[12] Ibid.

been relatively robust and the unemployment rate stood at 5 percent last month. Looking beyond those numbers, however, shows other pockets of the labor market remain weak. Some 5.9 million individuals were working part time in September due to poor economic conditions, roughly 42 percent higher than before the recession. A number of economists have blamed the Affordable Care Act for exacerbating this trend by creating incentives for part-time work.[13] This speaks to the persistence of a lack of viable job opportunities for many middle class Americans in this economy. Starting with the 7.9 million Americans conventionally defined as unemployed, then adding those working part-time because they cannot find full-time work and those who have simply given up looking for work, brings the broader "under-employment" rate to 9.7 percent, nearly double the headline rate (see Figure 2).

Figure 2

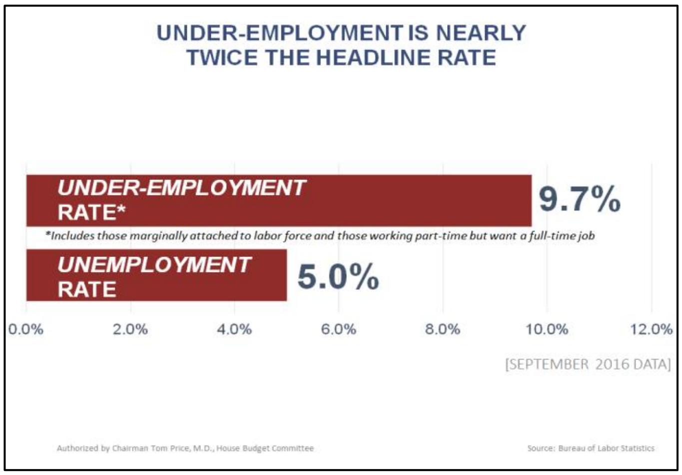
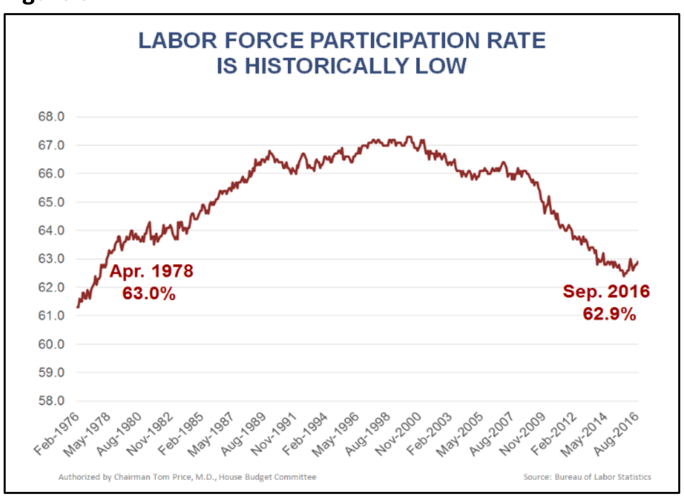


Figure 3

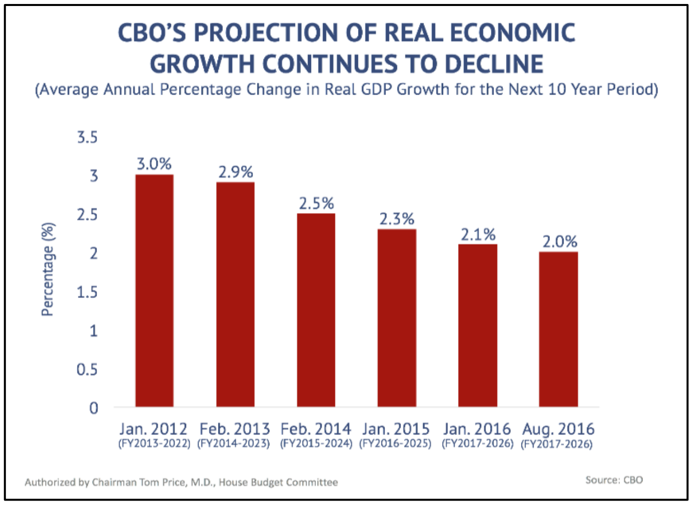


In addition, the labor force participation rate stands at just 62.9 percent, only slightly above the 40-year low of 62.4 percent reached late last year (see Figure 3). This means that more than 94 million Americans are now "on the sidelines" and not in the labor force, representing a nearly 14-million increase since early 2009. A portion of the decline

[13] See, for example, Casey B. Mulligan, *The Affordable Care Act and the New Economics of Part-Time Work*, The Mercatus Center at George Mason University, October 2014.

in the labor force is due to structural factors such as the aging and retirement of the large baby-boom generation. In addition, a segment of younger workers are choosing to stay in school longer instead of entering the labor force. Nevertheless, there has still been a sharp decline in labor force participation among those 25 to 54 years old – a group that presumably would be too old to be in school and too young to be retired. The labor force participation for this group has slipped from 83.2 percent in late 2008 to 81.5 percent currently. In short, absent the steep drop in labor force participation in recent years, the headline unemployment rate would be much higher.

Figure 4



Under current policies, the Nation's future economic plight seems to mirror the government's fiscal trajectory. CBO essentially expects subpar economic growth to continue indefinitely, forecasting that real GDP growth will average just 2.0 percent over the next decade (see Figure 4). That is well below the U.S. historical trend rate of roughly 3.0 percent growth. Similarly, this month the Federal Reserve Bank lowered its forecast of long-run U.S. real GDP growth to just 1.8 percent, well below the 2.5-percent long-run growth rate the central bank was predicting only a few years prior.

PRO-GROWTH REFORMS, NOT MORE OF THE SAME

Most economists agree stronger growth is essential to solving the government's fiscal challenges. "[R]estoring sustained, long-term economic growth is the key to just about every economic and budgetary problem we face," says economist John H. Cochrane, a Senior Fellow at Stanford University's Hoover Institution.[14] Holtz-Eakin concurs: "[M]ore rapid trend growth is the preeminent policy challenge" and "the most pressing […] issue facing the Congress."[15]

Increased economic growth results in greater taxable income and higher tax revenues, thus helping reduce deficits. Smaller deficits reduce the government's borrowing needs and lead to lower interest costs. According to CBO, if annual real GDP growth were just 0.1 percentage point higher for the next 10 years, deficits would be reduced by $327

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[14] Cochrane, op. cit.
[15] Douglas J. Holtz-Eakin, testimony before the Committee on the Budget, U.S. House of Representatives, 14 September 2016.

billion.[16] Hence, if the economy could return to its historical 3.0-percent annual real growth rate over the next decade, deficits could be reduced by $3.3 trillion, assuming all other economic variables remained the same.

Still, views differ considerably on how to foster growth and achieve fiscal sustainability. One line of argument holds that policymakers should take advantage of historically low interest rates and borrow more to spend on investments such as infrastructure repair and construction. This comes directly from the Keynesian economic playbook: borrow, increase government spending, and that will generate more consumer spending (through the famed "fiscal multiplier" effect), more jobs, and higher GDP growth. On the other hand, if more borrowing and government spending truly was the key to economic success, Americans already should be enjoying a golden age of economic prosperity given the government's run-up of red ink in recent years.

"Even if one believed that countercyclical fiscal policy ('stimulus') could be executed precisely and had multiplier effects, it is time to learn by experience that this strategy is not working. Checks to households (the Economic Stimulus Act of 2008), the gargantuan stimulus bill in 2009 (American Recovery and Reinvestment Act), 'cash for clunkers' (the Car Allowance Rebate System), tax credits for homebuyers (the Federal Housing Tax Credit), the HIRE Act (consisting of a $13 billion payroll hiring credit, expensing of certain investments, $4.6 billion for schools and energy, the Small Business Jobs Act of 2010, and the state-local bailout Public Law 111-226 ($10 billion in education; $16 billion in Medicaid) have all failed to generate adequate growth. As the policy regime of macroeconomic fiscal (and monetary) fine-tuning backfired in the 1960s and 1970s, leaving behind high inflation and chronically elevated unemployment, it is working no better in the 21st century."[17] This argument also neglects the likely rise in future interest rates. With the government's large stock of debt and this gradual increase in rates, interest expenses will absorb an ever-greater share of our Federal budget in the future, essentially crowding out other vital spending needs. Interest expenses are now the fastest growing segment of the budget. According to CBO, interest payments will increase by 187 percent over the coming decade, from $248 billion this year to $712 billion in 2026 (see Figure 5, next page). That would exceed the expected rate of growth in spending on major health care programs such as Medicare and Medicaid (81 percent) and Social Security (77 percent) over that same period. By 2026, an annual interest expense of $712 billion will be roughly on par with spending on national defense ($719 billion).

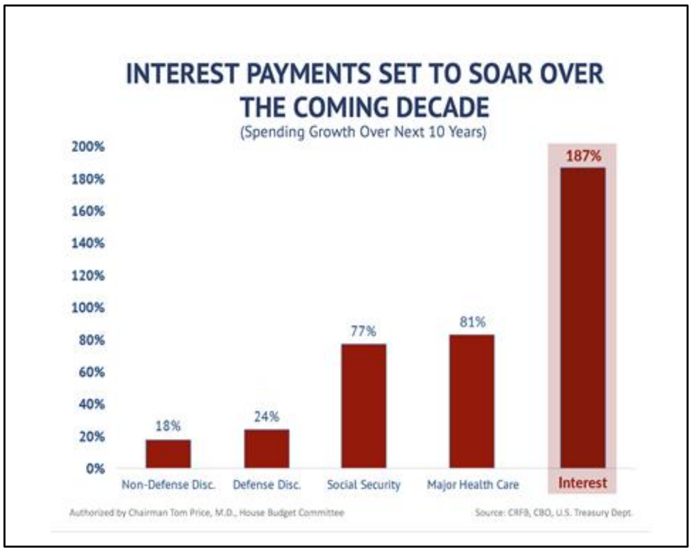
This situation is made even more precarious by U.S. reliance on foreign creditors to help fund its large stock of debt. Foreigners now own nearly half (45 percent) of all publicly held U.S. debt. This makes the U.S. vulnerable to a sudden shift in foreign-investor sentiment, particularly during a time of crisis. If foreign investors, for instance, begin to lose confidence in U.S. fiscal sustainability and long-term economic viability, the result could be a sizeable increase in interest rates as foreigners demand higher compensation to offset the perceived risk of holding U.S. debt.

In recent years, foreigners have flocked to Treasury debt in a global "flight to quality," which helped keep U.S. borrowing rates at record low levels. These investment flows, however, work both ways. As risk perceptions change, particularly with regard to sovereign credit, investors could one day seek to avoid U.S. debt, thereby driving up

[16] Congressional Budget Office, *The Budget and Economic Outlook: 2016 to 2026*, January 2016, Table B-1, p. 119.
[17] Holtz-Eakin, op. cit.

borrowing rates. In a worst case scenario, this dynamic could also lead to a full-blown debt crisis – and it could rise unexpectedly. "Debt crises, like all crises that really threaten an economy, do not come with decades of warning. Do not expect slowly rising interest rates to canary the coalmine. Even Greece could borrow at remarkably low rates. Until, one day, it couldn't, with catastrophic results. The fear in the US is similar. We will have long years of low rates. Until, someday, it is discovered that some books are cooked, and somebody owes a lot of money that they can't pay back, and people start to question debts everywhere. […] Now, bond investors are willing to lend to the US government so long as they think someone else will lend tomorrow to pay off their loans today. When they suspect that isn't true, they pull back and interest rates spike."[18] To put that risk in perspective, a sustained increase of just 1.0 percentage point on U.S. interest rates beyond the level currently projected would cause the deficit to balloon by an additional $1.6 trillion over a 10-year period.[19]

Figure 5



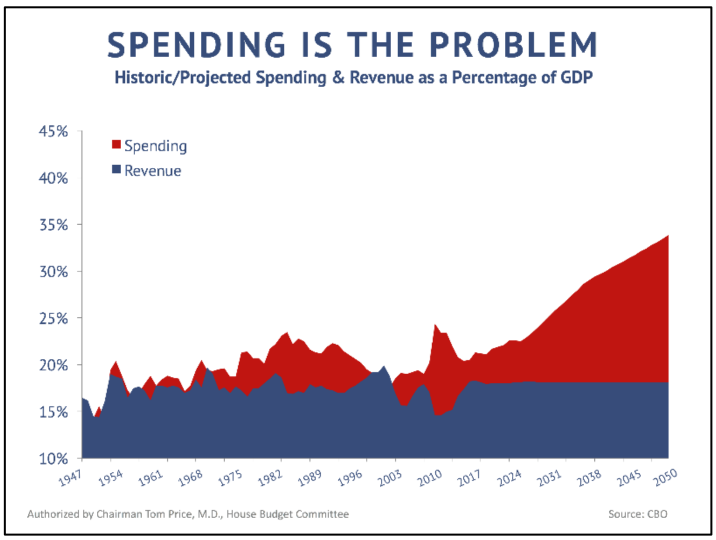
It is also questionable whether infrastructure spending is the economic panacea that some advocates make it out to be. "[T]he test for a high-productivity public investment is that it should generate a rate of return to society that exceeds the market return in the private sector. The resources for any public investment are ultimately drawn from the private sector through taxes and fees, or in some cases by borrowing from the private sector. In each case, the dollars used to make these investments constitute foregone opportunities to make other market investments."[20] In this regard, CBO recently concluded that "productive federal investment has an average annual rate of return of 5 percent, or half of the agency's estimate of the average rate of return on private investment."[21] Besides, any shift in resources creates losers as well as winners. "A dollar spent on any project means a dollar less to spend on another project. In an environment of finite resources,

[18] Cochrane, op. cit.
[19] Congressional Budget Office, *The Budget and Economic Outlook: 2016 to 2026*, January 2016, Table B-1: https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51129-2016Outlook.pdf.
[20] Holtz-Eakin, op. cit.
[21] Congressional Budget Office, *The Macroeconomic and Budgetary Effects of Federal Investment*, June 2016, p. 1, https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51628-Federal_Investment.pdf.

funding infrastructure projects will generate some productivity, but at the expense of jobs that could have been created in other sectors had the money been used differently."[22]

Another strategy calls for imposing higher taxes, particularly on those individuals or entities that presumably do not "pay their fair share," such as corporations. The flaw in this concept is that the government's unsustainable fiscal trajectory comes from out-of-control spending, mostly on ill-structured direct spending programs, not from a lack of revenue. CBO's latest estimates show Federal tax revenue this year will reach about 17.8 percent of GDP, above the 17.4-percent average of the past 50 years. Total spending, however, will exceed 21 percent of GDP,[23] and it will continue to outpace revenue over the next 30 years and beyond (see Figure 6 below).[24] Over the longer term, CBO projects that while tax revenue will increase to a historically high level of 19.4 percent of GDP in 2046, the government's programmatic spending – excluding interest payments – will reach 22.4 percent of GDP that year. The growing excess of spending over revenue – coupled with projected increases in interest rates – will cause debt service to double over the next decade, and reach 5.8 percent of GDP in 2046. Thus, total spending will exceed 28 percent of GDP in 2046.[25]

Figure 6



In addition, this policy of raising the corporate tax rate would be economically counter-productive and would actually harm those the advocates of such a policy purport to want to help. The U.S. corporate income tax sums to the highest rate in the industrialized world. The tax discourages investment and job creation, distorts business activity (by creating incentives for businesses to move the tax base offshore) and generally puts American businesses at a disadvantage against foreign competitors. Moreover, corporations, per se, do not pay the tax; the taxes are passed along to shareholders, employees, and customers. Workers pay the cost in lower wages, consumers in higher prices, and investors in diminished share returns. A survey of academic literature found

[22] Holtz-Eakin, op. cit.
[23] Congressional Budget Office, *An Update to the Budget and Economic Outlook: 2016 to 2026*, August 2016, Table 1.
[24] Congressional Budget Office, *The 2016 Long-Term Budget Outlook*, July 2016, Table 1-1.
[25] Ibid., pp. 13, 20.

that the corporate tax burden falls most prominently on labor (bearing 45 to 75 percent of the economic burden) in the form of reduced wages.[26]

Pro-growth policies hold the key to both reviving the economy and putting the budget on a sustainable path. "Structural reforms to entitlements, taxes, regulations, education, immigration, and trade agreements are the most promising policy mix to restore economic growth, generate rises in the standard of living, and lead to a sustainable budget outlook."[27]

CONCLUSION

The Federal Government's chronic deficit spending has pushed government debt to unprecedented peacetime levels. The debt further burdens an economy struggling through the weakest recovery of the modern era. These conditions also leave the Nation vulnerable to a full-blown debt crisis, which likely would come without warning.

Reverting to another round of Keynesian-style spending and borrowing, as some suggest, cannot solve these twin problems. Such a strategy would only add to the debt and worsen economic uncertainty. Besides, every dollar the government spends is a dollar not available for growth-producing activities in the private sector. Therefore, lawmakers should pursue pro-growth policies and strive to gain control of government spending and deficits. This is the most promising combination for bringing the economy back to its historical rates of growth and raising Americans' standards of living.

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[26] The Tax Foundation, *Ten Benefits of Cutting the U.S. Corporate Tax Rate*, May 2011: http://taxfoundation.org/sites/default/files/docs/sr192.pdf.
[27] Holtz-Eakin, op. cit.

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